

## Market Update: October 28, 2008

*By John Blood, CFA, Chief Market Strategist*

Investors these days might justifiably feel like they're riding a roller-coaster—in the dark. You thought you were mentally prepared and had braced yourself for the sharp turns that you knew

Date	S&P 500 Daily Close	Daily % Change
Oct. 20, 2008	985.40	+4.77%
Oct. 21, 2008	955.05	-3.08%
Oct. 22, 2008	896.78	-6.10%
Oct. 23, 2008	908.11	+1.26%
Oct. 24, 2008	876.77	-3.45%
Oct. 27, 2008	848.92	-3.18%
Oct. 28, 2008	940.51	+10.79%

lay ahead, but those turns came more fast and furious than you had expected, and there was no warning whether they would be up, down, or sideways. By the end, your nerves were shot and you just wanted off.

The continuing market gyrations of the last several months, including this past week's quite drastic volatility, could easily compel some to seek solace and calm on the sidelines. But those

sideline seekers would have missed today's stunning and unpredictable 10.79 percent rally, and so a total flight to safety is typically an ill-advised move for long-term investors, especially those who have the ability to withstand the inevitable future ups and downs. The time will come when the market bottoms, and disciplined investors will be greeted with an opportunity that may not be available to others who've jumped out of the coaster line—but that opportunity will come with neither warning nor fanfare.

Financial markets continue to be very jittery in responding to the sweeping changes that have reshaped the investment landscape in recent months. And to be sure, our nation and all other countries around the world face economic challenges going forward. But as several key themes continue to unfold—and will surely continue to ebb and flow in the weeks and months ahead—investors who find the fortitude to be contrarian may well be rewarded over the long haul.

### Key developments:

- Central banks in the U.S. and around the world continue to take steps to support and restore normalcy to global credit markets, which will allow deserving businesses and consumers to access credit at reasonable rates. For example, on October 27, the Federal Reserve (the Fed) commenced with its program to purchase commercial paper directly from qualified issuers. Though still early in the process, initial results from all actions taken thus far look promising, as interbank lending rates—the rates at which banks loan funds to each other—have trended lower in recent weeks.
- Policy responses continue to evolve in the face of ever-changing market conditions. We expect the Fed to lower its target federal funds rate at the conclusion of its October 28–29 meeting. And as we have anticipated in recent commentaries, Congressional rhetoric has increased calling for a new round of fiscal stimulus. On

October 20, in testimony before Congressional committees, Fed Chairman Ben Bernanke opined that a second fiscal stimulus package “seemed appropriate” in light of the tight credit environment, higher unemployment, and an overall weakening in economic conditions.

- Deleveraging—or selling assets to repay borrowed funds—continues across the financial spectrum. Banks and other financial institutions, which are inherently leveraged through their normal business activities, as well as some investment funds, including many hedge funds that chose to utilize leverage as a strategy to enhance investment returns, are selling assets of all types to deleverage themselves. Many leveraged hedge funds find themselves in a perfect storm, where lenders are unwilling to extend them new credit, investment losses have reduced available capital while also requiring them to post additional collateral to existing lenders, and investor redemptions and collateral calls have forced them to sell holdings. A whole host of such funds will likely close their doors as a result. Consumers are also deleveraging in many cases, for example by selling homes that they have found themselves unable to afford. This widespread deleveraging activity has put downward pressure on the prices of all types of assets—stocks, bonds, houses, and others—in the short term, but may also present opportunities for long-term investors who are not under any immediate pressure to sell.
- Many longer-term investors, spooked by declining asset prices or concerned about the potential adverse effects of a recession, have also pulled money to the sidelines, selling stock- and bond-related assets in favor of cash and other ultra-conservative investments. This selling by fearful investors exacerbates the supply-demand imbalance created by forced sellers and has contributed to the sharp price declines we have experienced.
- Beyond forced liquidations and emotion-driven selling, even rational investors might well have sought a safe haven from what they perceive as a deep, impending recession. These fears are not completely unfounded, as evidenced by slumping consumer sales in September—overall sales fell by 1.2 percent—and troubling unemployment. The nation’s unemployment rate in both August and September was 6.1 percent—the first time since 2003 that it has been 6 percent or higher for two consecutive months. On October 23–24, Goldman Sachs announced plans to cut 10 percent of its global workforce—part of an expected spate of job losses in the financial industry—and Chrysler indicated that it planned to shed up to 25 percent of its white-collar jobs, mainly in Michigan, as domestic automakers continue their fight for global competitiveness. These announcements are merely high-profile examples of the underlying trend of rising unemployment, which would only serve to intensify the theme of reduced consumer spending and higher savings rates we expect to see going forward.

### **Have we gone too far?**

In my August commentary, I asserted that I would not be surprised to see the S&P 500 fall from its then current level of 1,270 down to as low as 1,025—a decline of nearly 20 percent—and that it was a good time to consider a more defensive stance in investment portfolios. Since then, we have experienced a sea change in the global financial system, and the index had dropped to 848 entering today’s trading—a precipitous fall of 33 percent in eight short weeks. Today, we

experienced a remarkable 10.79 percent rally, which marked a stunning reversal of the recent downdraft. Are current market valuations a reasonable reflection of the expected economic conditions going forward? Or, even after today's rebound, do they reflect a doomsday scenario that is fairly unlikely to play out, and do they therefore represent a potentially attractive opportunity for long-term investors?

At times of extreme investor pessimism, it is important to remind ourselves that underlying the "stock market" are real companies selling real goods and services. A company's stock price is, at best, a snapshot approximation of investors' aggregate expectations for the future earnings of that company—and, at times, investors can overshoot on both sides of the mark. At a superficial level, market valuations currently imply an expected reduction in future corporate earnings, as follows:

Market Price = Actual Earnings x Valuation Multiple

or

$P = E \times P/E$

At current price levels for the S&P 500 (940), and using the long-term historical average valuation multiple (16), we come to the conclusion that the market expects aggregate earnings on the index to fall to \$58.75 for 2008—a 12-percent decline from 2007's actual reported earnings of \$66.18. Interestingly, S&P's own analysts' forecast for full-year 2008 earnings stands at \$54.82 as of October 15. If you think earnings could conceivably fall below that range given your outlook for unemployment, consumer spending, and overall economic activity, the inevitable conclusion is that the market could move lower from here. If, on the other hand, your expectation is that reported earnings will be better than \$59, the market will most likely follow them higher and now could be an opportune time to invest.

Year	S&P 500 Actual Earnings
2008	?
2007	\$66.18
2006	\$81.51
2005	\$69.93
2004	\$58.55
2003	\$48.74
2002	\$27.59
2001	\$24.69
2000	\$50.00

At Commonwealth, we have monitored third-quarter earnings closely, and have undertaken an analysis of year-to-date earnings for all S&P 500 companies as compared to earnings for the same period in 2007. To date, 2008 corporate earnings have fallen by 37 percent as compared to 2007. So while the market price of the index currently implies an expected 12-percent earnings reduction for the full year (assuming a constant 16x P/E multiple), the actual earnings decline on a year-to-date basis is on the order of 37 percent. We do not believe, given current conditions, that the fourth quarter holds in store a drastic economic recovery. As such, it appears feasible that stock indices may yet retreat a bit from current levels before all is said and done.

### **Long-term investor response**

An analysis that concludes that stock prices in aggregate might fall further could theoretically spur an investor to retreat from all such investments. The most important word in that sentence, however, is *might*. There is no such thing as infallible analysis, no crystal ball for earnings forecasts, and no market prognosticator who will ring a bell precisely at market tops and bottoms. And so in this case, we espouse the exact opposite approach—holding that the key to

the long-term accumulation of wealth is to continue to accumulate investments that are well suited to your individual risk tolerance and time horizon, and to take advantage of the opportunity to do so when prices are attractive. “Buy low, sell high,” as the old saying goes.

For investors with shorter time horizons, or those with little appetite to patiently wait out market swings, it makes sense—and always has—to hold a more risk-averse portfolio of assets. For long-term investors, we view the current environment—one categorized by extreme pessimism, systematic deleveraging, and forced selling—to be a time when temporary market forces now have the entire herd moving in one direction, making this an attractive time for true long-term investors to continue along the path of building long-term wealth. Those assets might well fluctuate a bit in the short run, but in the long run, we believe those investors will be rewarded for their persistence.

In the words of legendary value investor Benjamin Graham:

- The intelligent investor is likely to need considerable willpower to keep from following the crowd.
- In the short run, the market is a voting machine but in the long run it is a weighing machine.
- Individuals who cannot master their emotions are ill-suited to profit from the investment process.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks.*

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